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Nos. 16 and 17

In the Supreme Court of the United States

OCTOBER TERM, 1928

ELIZABETH C. PEET, PETITIONER

v.

FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF NEW YORK

GILBERT C. GRISWOLD, JR., PETITIONER

v.

FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF NEW YORK

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

SUPPLEMENTAL BRIEF FOR THE RESPONDENT ON RECONSIDERATION

(4)

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In the Supreme Court of the United States

OCTOBER TERM, 1928

No. 16

ELIZABETH C. TAFT, PETITIONER

v.

FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE for the Second District of New York

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No. 17

GILBERT C. GREENWAY, JR., PETITIONER

v.

FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE for the Second District of New York

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ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

SUPPLEMENTAL BRIEF FOR THE RESPONDENT ON REARGUMENT

STATEMENT

These cases are now before the Court upon reargument. The question presented in each is whether or not Section 202 (a) (2) of the Revenue

Act of 1921, which requires the donee upon the sale of property acquired by gift after December 31, 1920, to use the cost of the property to the donor as the basis for computing profit, is constitutional in so far as it taxes as income to the donee the appreciation in the value of the gift prior to its acquisition by the donee.

The facts in detail, as well as the constitutional amendment and the statutes involved, are set forth in the respondent's first brief.

SUMMARY OF ARGUMENT

In respondent's first brief it was contended that gifts are inherently income which Congress may lawfully tax or exempt from taxation in its discretion. That contention is adhered to in this brief, and additional grounds are suggested upon which it is believed the validity of the statute touching the tax in question may be upheld.

Congress assumed the gift of a corpus which it exempted from taxation, but it taxed the income from the gift. *Irwin* v. *Gavit,* 268 U. S. 161. In the cases at bar the corpus was the shares of stock conveyed by gift. The increment in the value of these shares when realized by sale was income. *Eisner* v. *Macomber,* 252 U. S. 189. That part of the increase which accrued while the stock was still held by the donor was inherently income. It was intrinsically a gift of income to the donee, and when separated from capital and realized in the hands of the donee by the sale of the gift may constitu-

tionally be taxed as income to him for the year in which realized.

Since the authority to tax given by the Sixteenth Amendment to the Constitution is an authority to tax "income," not "persons," a change in ownership of what is inherently income after its accrual and before realization by sale can not affect the right of Congress to impose a tax thereon. *Atlantic Coast Line* v. *Daughton,* 262 U. S. 413, 420; *United States* v. *Phellis,* 257 U. S. 156; *McKinney* v. *United States,* 62 C. Cls. 180; *Irwin* v. *Gavit,* 268 U. S. 161; *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509.

If the corpus of the gift in these cases be construed as including the increment in the value of the shares of stock while held by the donor, still the sale of the gift resulted in a realized gain which may be constitutionally measured by taking the cost of the latest actual capital investment in the gift as a basis.

Section 202 (a) (2) of the Revenue Act of 1921 does not prescribe a capricious nor arbitrary scheme of taxation, nor is it in violation of the Fifth Amendment to the Constitution of the United States. It is a necessary part of a complete scheme of taxation whose purpose was to prevent tax evasion or avoidance in respect to a particular type of gain.

It is not capricious to put property acquired by gift in a special class and to tax it differently from property acquired by purchase. *Bowman* v. *Con-*

tinental Oil Co., 256 U. S. 642; *Brushaber* v. *Union Pacific R. R. Co.,* 240 U. S. 1; *Thomas* v. *United States,* 192 U. S. 363.

ARGUMENT

I

RESPONDENT'S FIRST BRIEF SUMMARIZED

These cases present a novel question. Previous decisions of this Court can not be relied on as controlling. None of them is opposed to the views here urged. Most of them, we believe, support such views.

At the original argument we contended that the tax prescribed by Section 202 (a) (2) of the Revenue Act of 1921 on the gain derived from the sale of property acquired by gift after December 31, 1920, is sustainable on the ground that a gift is intrinsically income; that Congress had authority to tax it in its entirety and, hence, that it could tax or could exempt from taxation whatever part thereof it might see fit.

We adhere to this theory and still urge that it affords a correct basis for the decision of the pending question, but we also suggest other theories upon which we believe the validity of the statute may be upheld.

The argument advanced on behalf of the Government in its first brief may be summarized as follows:

1. In considering the meaning to be given to the word "income" as used in the Sixteenth Amendment and in the Revenue Acts pursuant thereto, the courts have consistently construed the word in its ordinary sense and as it is used in common speech, giving to it "what is believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constiution." *Merchants' Loan and Trust Co.* v. *Smietanka,* 255 U. S. 509, 519. (Brief, pp. 10, 11.)

2. Congress in the various Revenue Acts has consistently treated gifts as income; one time, as in Section 4 of the Revenue Act of 1916, specifically referring to gifts as "income," but generally by exempting them from inclusion in gross income, something which would apparently have been wholly unnecessary if it did not consider that without this specific exemption gifts would be treated as gross income within the general definition of that term. (The statutes making such exemptions are cited in a note at the bottom of page 12 of the respondent's first brief.)

3. The legislatures of certain States have regarded gifts as income. (Brief, p. 14.)

4. The sale of purchased property separates income from capital. The income is measured by the difference between the investment and the selling price. If this rule be applied to the sale of property acquired by gift, the value of the gift, i. e., its

selling price, will appear as income, since the donee's investment therein is zero. (Brief, pp. 15, 16.)

5. This conception of income is not inconsistent with the definition of income in *Eisner* v. *Macomber,* 252 U. S. 189, but in any event that definition, as the Court there intimated, does not represent the uttermost limits of what can be regarded as income. (Brief, pp. 16, 17.)

6. Congress intended the donee to step into the shoes of the donor and, while taking the corpus of the gift tax free, to take it charged with the tax on the gain which might then be realized if the gift were sold or converted. (Brief, p. 24.)

7. The Sixteenth Amendment authorizes a tax on income, not on persons (Brief, p. 25), and Congress may postpone the tax in the case of the sale of a capital asset until the sale separates the income from capital. (Brief, pp. 28, 29.)

8. There was a practical necessity for the statute in order to obviate the avoidance of taxes on gains realized from the sale of property acquired by gift, as set forth in report of the Senate Committee on Finance on the Revenue Bill of 1921. (Brief, pp. 27–28.)

9. The statute is a necessary part of an entire taxing scheme and sustainable as such. (Brief, p. 30.)

10. The ordinary presumption in favor of the validity of a statute is strengthened here by the fact

that objection to the validity of Section 202 (a) (2) of the Revenue Act of 1921 arises not out of specific limitations or prohibitions on the exercise of Congressional power, but out of the "vague contours of the Fifth Amendment prohibiting the depriving any person of liberty or property without due process of law." *Adkins* v. *Children's Hospital*, 261 U. S. 525, 568. (Brief, p. 30.)

II

ADDITIONAL REASONS FOR UPHOLDING THE VALIDITY OF THE STATUTE

(a) The increment in the hands of the donor may be treated as a gift of intrinsic income to the donee and taxable upon realization

To sustain the statute it may not be necessary to hold that all gifts are inherently income to the donee. For the purpose of these cases it is sufficient if a gift of what is intrinsically income (as income has been heretofore defined by this Court) may be treated as income to the donee. Petitioners' contention deals solely with the portion of the gift which represents the increment which had accrued in the hands of the donor prior to the gift. There can be no doubt but that such increment is inherent income—a gain or profit produced by the donor's investment. While such increment remains unsevered from the capital investment it is not taxable income, but it is none the less intrinsic income and will become taxable income upon sever-

ance by sale. In *Irwin* v. *Gavit,* 268 U. S. 161, 167, this Court said:

> The money was income in the hands of the trustees and we know of nothing in the law that prevented its being paid and received as income by the donee.

Why may not the gift of such intrinsic income be properly regarded as intrinsically income to the donee? In reality the donor in each of these cases gave to the donee two things of quite different character. He gave the share of stock and he also gave the increment which had accrued to that share of stock. The distinction is more evident in the case of a gift of a bond with coupons attached. In that case there is a physical separation between the bond and its increment, but the distinction is just as real in the case of a stock certificate, even though there may not be a physical separation. The distinction is clearly illustrated by Judge Learned Hand, writing the opinion of the court in *United States* v. *Oregon-Washington R. & N. Co.,* 251 Fed. 211. In holding that under the circumstances of that case the cancellation of a debt was a contribution to capital he said (p. 213):

> We regard the difference as precisely equivalent to the difference between the cancellation of a portion of the mortgage bonds and a cancellation of an equal proportion of their coupons. Common usage would, if we are right, unfailingly allocate the first as an increase in capital assets and the second as

an increase in income. That, as we view it, is the proper test of the act.

Accordingly, we submit that the intrinsic character of the increased value of these securities which had accrued in the hands of the donor distinguishes it from the capital investment in the securities and that when it was transferred to petitioners it constituted a gift of intrinsic income to them. The statute does not attempt to tax it as income until it is actually released by sale, and we contend that upon sale it was correctly taxed as income, in the same manner and to the same extent as the subsequent accretion in value in the hands of the donee, which it is admitted is properly taxable. The amount of the accretion in value in the hands of the donor is identical in character with the subsequent accretion in the hands of the donee. Both were intrinsically income and both were properly taxed upon realization. Together they represent the gain derived from the capital investment and their sum represents the taxable income resulting from the investment.

The same result will be reached by distinguishing the right to the increment from the realization thereof. The capital element in each gift is wholly comprised within the right acquired by the donee, as distinguished from the fruit it produces. In the same manner this Court distinguished between the beneficiary's interest in a trust fund and the receipt of the income from that fund. *Irwin* v. *Gavit,* 268 U. S. 161. That case indicates that the gift of the

income of a trust fund may result in taxable income to the donee, and we submit that the transfer by way of a gift of the right to receive the unrealized increment adhering to it likewise results in taxable income when the donee receives it through sale.

(*b*) *A change of ownership prior to realization of the income does not render the tax invalid*

The authority given by the Sixteenth Amendment is to tax "income" not "persons." If what has been taxed is income, the fact that it happens to be taxed in the hands of the donees is unimportant in view of the fact that they were sole recipients and beneficiaries of the funds on which the taxes were laid.

It has been held that a State may lay a tax on the income of property as distinguished from the income of him who owns it (*Atlantic Coast Line* v. *Daughton,* 262 U. S. 413, 420), and there would seem to be no inhibition against this principle as applied to the Federal Government.

Nor do we perceive any reason why Congress may not provide that the donee shall step into the shoes of the donor and receive the gift charged with all accumulated profits capable of immediate realization, and impose an income tax upon the whole gain realized or derived by the donee when the property is sold by him. The principle that accumulated gains are taxable as income when realized, despite the fact that they may appear to constitute a portion of capital, was applied in the case of

United States v. *Phellis*, 257 U. S. 156, where the Court said (pp. 171–172):

> The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company

> profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

The case of *McKinney et al.* v. *United States,* 62 C. Cls. 180, has a bearing on the point now under discussion. McKinney died April 28, 1918, leaving as a part of his estate certain shares of stock, appraised at $67,200 as of the date of his death. These shares had been purchased prior to March 1, 1913, at a cost of $177,131.90 and their market value on March 1, 1913, was $187,200. They were sold by the executors for $160,311.75. This was $93,111.75 more than the appraised value at the date of the testator's death. The Government contended in that case that this appraised value should be taken as the basis for measuring the taxable gain which was realized on the sale of the stock, but the Court of Claims, despite the fact that the statute treats the estate as a separate taxable entity, disregarded the change of title and ownership and held that the statute had for its purpose the taxation of gains derived from the sale of property based upon the difference between the original investment made by the decedent and the sale price realized by the executor. The Court said in this connection (pp. 187–188):

> Defendant is also contending that the sale by the executors creates a different situation from that which would have existed had the sale been made by McKinney himself, and it in effect asks the court to consider as the cost

of the property, not the purchase price, but the appraised value of it at the time of the testator's death, as though it had cost them that amount. Of course, there was no cost to the executors. They were the personal representatives of the decedent. The stock was the same stock as it had been in the hands of the decedent, and, as stated, had he lived and sold the stock himself there would have been no question of taxable gain. The fact that they were executors did not alter the situation.

In the case of the *Mercantile (sic) Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509, which was a sale of assets by trustees of a fund under a will, the Government's brief contended for the following position:

"The gains received by a trustee under a will by the profitable sale of capital assets purchased by the testator in his lifetime are measured in precisely the same way they would have been measured if the latter had lived and made the sale himself."

And this view of the matter was accepted by the court as is evident from its decision.

A petition for a writ of certiorari was denied in that case. (273 U. S. 716.)

It is but fair to say that in *Bankers Trust Co.* v. *Bowers,* 23 F. (2d) 941, the District Court for the Southern District of New York disagreed with the Court of Claims' decision in the *McKinney* case, and held that the value at date of death is the proper basis. It should also be said that the prin-

ciple announced in the *McKinney* case has not been acquiesced in by the Treasury Department or by the Department of Justice.

That there are flaws in the contention of petitioners that earnings of capital in order to be income to the recipient within the meaning of the Sixteenth Amendment must have accrued or have been derived from capital actually owned by the recipient of the income, is indicated by the decisions of this Court in *Irwin* v. *Gavit, supra,* and *Merchants' Loan & Trust Co.* v. *Smietanka, supra.*

(*c*) *Upon the sale of a gift by the donee the taxable gain may be constitutionally measured by taking as a basis the actual investment of the donor*

Assuming for the purpose of argument only that the gifts in these cases were wholly contributions to the capital of the donees, there is no sound reason why that capital may not be measured by its cost. There is nothing in the theory of taxation, nor in the Sixteenth Amendment, which requires that the *value* of the capital must be returned before a profit is realized on the sale or conversion of a capital asset. On the contrary, the theory is that after the *cost* of the capital is returned the remainder of the selling price is income. If the cost of the capital is taken as the measure for determining gain, then it is clear that the increment which accrued in the hands of the donor in these cases will fall into the classification of income. This principle of measuring capital investment applies in the case of

inventories of merchandise which are valued at (*a*) cost or (*b*) cost or market, whichever is lower. *United States* v. *Kemp* (C. C. A. 5th), 12 F. (2d) 7. Thus, a merchant does not recover the value of the goods purchased in determining whether he has made a gain unless such value is less than cost and he has adopted that practice for inventorying his merchandise.

The petitioners contend in these cases that the value of the property at the moment of gift is capitalized and that it can not thereafter be taxed as income in their hands. It is true that when property passes by sale the purchase price becomes the invested capital for the purpose of measuring gains on resale. This is not due, however, to the fact that there has been a transfer of ownership, but solely to the fact that a new investment has intervened.

These gifts cost the donees nothing. Yet they claim a capital investment therein greater than would be the case if they had purchased the properties for any sums less than those which they now claim to have been the values of the stock when the gifts were made. An increased capital is thus claimed as the basis for exemption from taxation without any attempt to show a corresponding increase in capital investment. In effect this is asking that a part of the profit or gain in the value of the property, represented by the difference between the actual capital investment and the claimed capi-

tal value at the time of transfer by gift, should be allowed to escape taxation entirely. This is inequitable, and before it can be said to be required by any provision of the Constitution such requirement should, it seems to us, be clear and unmistakable. The collection of the tax in question from the donees imposes no hardship upon them, and it is difficult to see how Congress could have otherwise provided a workable system for the collection of an income tax on the whole gain derived from the sale of property acquired by gift. We believe that this statute should be regarded as an integral part of an entire taxing scheme found necessary by Congress in satisfying the needs of the Government for revenue. This Court has often recognized that a measure may be valid as a necessary adjunct to something which clearly lies within the legislative power, even though standing alone its constitutionality might have been subject to doubt. *Purity Extract Co.* v. *Lynch,* 226 U. S. 192; *Ruppert* v. *Caffey,* 251 U. S. 264; *Everard's Breweries* v. *Day,* 265 U. S. 545, 560.

III

SECTION 202 (A) (2) OF THE REVENUE ACT OF 1921 IS NOT CAPRICIOUS NOR ARBITRARY NOR CONTRARY TO THE FIFTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES

In Section 213 (b) (3) of the Revenue Act of 1921 Congress exempted from taxation the value of property acquired by gift, bequest, devise, or de-

scent, but in that same section it reserved the right to tax the income from such property. This reservation is obviously as broad as the meaning of "income" as used in the Sixteenth Amendment and as defined by this Court in *Eisner* v. *Macomber, supra.* It includes "profit gained through a sale or conversion" of the property acquired by gift. For measuring the income derived in these cases Congress has provided in Section 202 (a) (2) of the Revenue Act of 1921 that "the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift."

As said by the Circuit Court of Appeals in these cases (*Taft case,* R. 17–18):

> The obvious purpose of Section 202 (a) (2) was to prevent the loss of income represented within the profit to the donor during the period he held the property before he made his gift. Congress has determined that this same increment shall be recognized as income even though a gift intervenes. The transfer by gift is but a change of ownership in the specific property. In doing this, Congress imposes no tax upon an unrealized gain. * * * This statute puts the donee, who pays nothing for the property, and who therefore loses nothing, on any theory of economic principle, in the position the donor would have been, in so far as taxation is concerned.

The court further says (*Taft case,* R. 19–20):

> The statute does no more than tax the donee for a gift when he sells it, and measures that income for income tax purposes as based upon the difference between the cost when acquired by the donor and the price realized by the donee. It is not capricious to put property acquired by gift in a special class, and to tax it differently from property acquired by purchase. *Bowman* v. *Cont. Oil Co.,* 256 U. S. 642; *Brushaber* v. *Union Pacific R. R. Co.* 240 U. S. 1; *Thomas* v. *United States,* 192 U. S. 363.

If property acquired by purchase is later resold, only the value of the investment may be excluded from gross income. If a gift of the property intervenes between its purchase and its sale, no sound reason can be advanced why any value greater than that of the investment in the property should be excluded from gross income. The statute does not permit it and the Sixteenth Amendment does not require it, nor do we think it is required by the Fifth Amendment. It would be against the common understanding of the Constitution and the taxing statutes to suppose that the owner of property could make it any more tax-free or tax-exempt by giving it away than it would be if he retained it and dealt with it himself exactly as the donees in these cases have done. If property acquired by gift were treated under the statute as property acquired by purchase and the value of the owner's investment therein taken as the basis for deter-

mining the profit realized on the sale thereof, the entire sale value would appear as profit since the donee's investment is zero. This is another way of demonstrating the proposition advanced in the respondent's first brief that gifts are inherently income, and illustrates the measure of exemption which Congress saw fit to grant when it provided that the corpus of a gift should be exempt from taxation but that all income derived therefrom should be taxed. (*Irwin* v. *Gavit, supra.*)

CONCLUSION

For the reasons set forth herein, as well as for the reasons set forth in respondent's first brief, it is respectfully submitted that the decision of the Circuit Court of Appeals in these cases should be affirmed.

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